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EXECUTIVE SECRETARIAT

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Executive Secretary

10/27/82

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[with note: "An interesting paper. Worth reading."]

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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Executive Registry
82-12728

DATE: 10/25/82 NUMBER: 077559CA DUE BY:

SUBJECT: Cabinet Council on Economic Affairs - October 27, 1982 11:00 a.m. in Room 208 OEOB

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☐	☑
CEQ	☐	☐
OSTP	☐	☐
	☐	☐
	☐	☐

	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☐	☑
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
Wheeler	☐	☑
Kudlow	☐	☑
	☐	☐
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	☐	☐
	☐	☐
	☐	☐
CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: The Cabinet Council on Economic Affairs will meet Wednesday, October 27 at 11:00 a.m. in Room 208. The agenda and papers are attached.

RETURN TO:

☐ **Craig L. Fuller**
Assistant to the President for Cabinet Affairs
456-2823

☑ **Becky Norton Dunlop**
Director, Office of Cabinet Affairs
456-2800

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Attachment

THE WHITE HOUSE

WASHINGTON

October 25, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Paper for the October 27 Meeting

The agenda and papers for the October 27 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 11:00 a.m. in Room 208 of the Old Executive Office Building.

The Council is scheduled to review two related issues — the Japanese yen exchange rate and Japanese financial market restrictions. These issues have attracted a good deal of attention in many business circles and several observers have alleged that the Japanese yen is undervalued. Some of these observers claim that the undervaluation results from deliberate financial manipulation by Japan designed to enhance the competitiveness of its exports.

The Department of the Treasury and the Council of Economic Advisers have prepared a discussion paper on issues raised by the value of the Japanese yen and Japan's financial market restrictions to serve as the basis for the Cabinet Council's discussion. A copy of this paper is attached.

Attachments

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Attachment

THE WHITE HOUSE

WASHINGTON

THE CABINET COUNCIL ON ECONOMIC AFFAIRS

October 27, 1982

11:00 a.m.

Conference Room 208

AGENDA

1. Yen - Dollar Relationship (CM#319)

2. Japanese Financial Market Restrictions (CM#320)

October 25, 1982

To: Mr. Roger B. Porter

From: Martin S. Feldstein
Marc E. Leland

Attached is a Treasury-CEA paper on issues raised by the value of the Japanese yen and Japan's financial market restrictions.

The Japanese Yen Exchange Rate and Japanese Financial Market Restrictions

SUMMARY

Issue

- Various business groups and observers allege that the Japanese yen is undervalued. Many of these claim that the undervaluation results from deliberate financial manipulation by Japan designed to enhance competitiveness of its exports.

Corrective Actions Proposed by Critics

- The critics suggest a number of remedies (some contradictory). These range from liberalization and internationalization of the Japanese financial system to the imposition of capital controls on outflows. Some propose a change in the U.S. and Japanese fiscal and monetary policy mix to reduce the interest rate differential; some advocate coordinated exchange market intervention; others suggest U.S.-initiated action against Japan in the IMF and imposition of a variable import duty to offset "undervaluation".

Assessment

- Although it is difficult to make a judgement on whether a currency is under or over valued, there is no reason to conclude that the Japanese yen is more undervalued than the currencies of our other major competitors. Similarly, there is no reason to believe that the Japanese Government has done anything to reduce the value of the yen. Persistent undervaluation would tend to produce a large current surplus and/or excessive reserve build-ups. But in the period from 1973 to 1981, Japanese reserve accumulations were on average no greater than in other countries; and the average Japanese current account surplus as a share of GNP was slightly less than that of the U.S. and far smaller than that of Germany. While purchasing power measures -- which are used by the business groups -- are imprecise and should not be used to measure the "correctness" of rate levels, even purchasing power calculations suggest that the yen is less "undervalued" than the German mark and French franc. But exchange rates reflect myriad factors and can frequently differ substantially from measures of their relative purchasing power levels.

- Japan has significantly liberalized controls on both inward and outward flows in recent years, partly in response to U.S. pressures. Increased liberalization is reflected in a growth of capital flows in and out of Japan.

- Substantial controls on capital flows still remain, largely via administrative guidance and informal suasion. Outflow controls primarily have the effect of limiting foreign access to raise yen financing in Japan, though such access is presently increasing. A principal motive of Japan in maintaining these controls at present appears to be to limit downward pressures on the yen.

- The low Japanese interest rate structure primarily reflects Japan's low inflation. It is doubtful that any upward pressures on interest rates that would be associated with increased liberalization would be sufficient to attract offsetting capital inflows.

- In the short term, greater access to both Japanese goods and financial markets tends to exert downward pressures on the yen. In the long term, it is difficult to judge what the net effect would be: demand for yen for use internationally would increase, but so would the ability of Japanese residents to channel their high savings to overseas financial centers.

- There are factors specific to Japan which explain the yen's current weakness: external performance in 1982 is far weaker than previously anticipated, as reflected in declining export volume; net capital outflows from Japan this year have been extremely large.

- The Japanese Government's statements that it favors a stronger yen are credible. The Japanese authorities have intervened vigorously in the exchange markets in support of the yen this year and have pushed short term interest rates higher in order to attract inflows, contrary to domestic economic objectives.

POSSIBLE U.S. POLICY RESPONSES

The paper concludes that the USG should:

- Speak with one voice on the exchange rate issue: the yen is not artificially depressed by Japanese manipulation; the yen's behavior is not out of line with that of other major currencies; the "purchasing power" measures used by the business groups are not a practical guide to assessment of exchange rate developments or to "right" rates.

- Continue to press Japan to open its financial system to foreign participation, recognizing that this is a good thing for the U.S. even though it may add downward pressure on the yen in the short term.

- Support Japanese efforts to control budgetary expenditures and deficits.

- Oppose suggestions to urge Japan to try to strengthen the yen through exchange market intervention or capital controls, and calls for the U.S. to intervene in support of the yen.

- Not initiate IMF action against Japan.

- Oppose any suggestions to impose a variable import duty on U.S. imports from Japan.

THE JAPANESE YEN EXCHANGE RATE AND JAPANESE FINANCIAL MARKET RESTRICTIONS

A. ISSUE

Recently much of the tension in U.S.-Japan economic relations has become focused on the assertion that the yen is undervalued relative to the dollar. Various representatives of the private sector are raising vigorous complaints about damaging effects of Japanese financial policies and practices on U.S. interests. These complaints focus on two interconnected issues: the claim that the yen is undervalued -- giving Japan a significant competitive edge -- and the argument that Japan's financial restrictions cause this yen undervaluation. A long study by the Caterpillar Tractor Company, a shorter study by the Ford Motor Corporation, and statements by such figures as Michael Blumenthal and C. Fred Bergsten have argued that undervaluation of the yen has become the central problem in trade relations between the two countries. This paper examines these issues and draws conclusions for U.S. policy.

1. Complaints that the yen is undervalued

The complaints about the yen are of two kinds. The first is the assertion that the yen has been persistently undervalued; that throughout the 1970s and early 1980s, with the possible exception of a brief period in 1978-79, the yen was below its "proper" level. This assertion often is tied to the view that Japan should be pressured into changing its policies in such a way as to raise the yen to some particular value, usually between 180 and 200 yen per dollar.

The other complaint focuses on the recent depreciation of the yen, from 220 to the dollar at the end of 1981 to 270 in recent weeks. This complaint alleges that the decline in the yen is exacerbating the effects of recession in the U.S. while insulating the Japanese economy to some extent from the slump.

The perception that the yen is undervalued comes from three main sources. First is the large Japanese trade surplus, particularly in manufactured goods. Second is the apparent cost advantage of Japanese firms in many industries. Third is the existence of a number of Japanese practices which are alleged to hold down the yen's value.

2. Complaints about the causes of alleged yen undervaluation

A prevailing theme in the commentary is that the yen is maintained at an artificially low level by Japanese government actions designed deliberately to enhance the competitiveness of Japanese exports.

The various critiques conclude that yen "undervaluation" is brought about by some or all of the following:

- Japanese manipulation of capital inflows and outflows to influence the value of the yen;
- Restrictions on access to the Japanese capital market;
- Japanese accumulation of foreign exchange reserves through foreign exchange market intervention and a failure to sell interest receipts on dollar reserve holdings in the market;
- Low Japanese interest rates which are maintained by preventing Japanese financial integration with the rest of the world;
- Differences in the relative fiscal/monetary policy mixes in Japan and the United States;
- A lack of foreign confidence in the ability to move flows in and out of Japan and speculate in yen due to the perception that the Japanese financial market is tightly controlled and subject of abrupt policy changes; and
- Large Japanese capital outflows caused by high U.S. real interest rates and recent Japanese liberalization measures.

B. CORRECTIVE ACTIONS PROPOSED BY CRITICS.

- Most critics call for liberalization and internationalization of the Japanese financial system. They feel such action would strengthen demand for yen by increasing foreign use of the yen as a reserve and portfolio asset (and in the financing and invoicing of global trade) and by raising the Japanese interest rate structure. This group of observers focuses on seeking to provide U.S. firms with free competitive access to yen financing. (Caterpillar, NAM, James C. Abegglen of Boston Consulting Group; majority of Japan-U.S. Businessmen's Conference).
- Some propose that the U.S. reduce its budget deficit and relax monetary policy and that Japan increase its budget deficits and raise interest rates in order to bring about a narrowing in U.S.-Japanese interest differentials. (Japan-U.S. Businessmen's Conference)
- In addition to a change in the policy mix, former Treasury Secretary Michael Blumenthal, a member of the Japan-U.S. Businessmen's Conference, proposes that Japan impose

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capital controls, such as an interest equalization tax, to reduce capital outflows from Japan. Solutions of this kind are also advocated by the OECD Secretariat staff and former Treasury Assistant Secretary C. Fred Bergsten.

- Caterpillar Tractor Company further argues that Japan should sell its interest earnings on its dollar reserves in the exchange market and that the failure to do so is a form of "disguised intervention" to hold the yen down.

- The NAM proposes that the U.S. should take action against Japan's undervaluation of the yen in the International Monetary Fund (IMF).

- Ford Motor's analysis concludes that greater access to the Japanese financial system in the intermediate term coupled with the Japanese propensity to export capital will tend to depress the yen, though lower U.S. real interest rates, U.S. economic recovery, and exchange market intervention could improve the present situation.

- We have had indications that the Business Roundtable is considering proposing the imposition of a variable import duty on U.S. imports from countries with "undervalued" currencies (presumably aiming at the yen).

Thus the solutions proposed by the various commentators and groups are not always consistent. There is a particular contradiction between those who stress access to Japan's capital market (i.e. greater capital outflow) and those who believe that strengthening the yen requires greater constraints on capital outflows.

C. ASSESSMENT

1. An Undervalued Yen?

As described in Section A of the report, two allegations have been made about Japanese policy towards the yen. The first is that the yen has been kept persistently undervalued. The second is that, whether or not this is the case, the yen is currently being driven down to gain competitive advantage in a recession. The data does not appear to support either assertion.

Persistent undervaluation: There is no simple way to determine whether an exchange rate is out of equilibrium. However, if a currency were persistently kept undervalued we would expect to see two symptoms: first, a rapid accumulation of reserves, more than would be required to keep up with inflation and a growing volume of trade; second, a current account surplus which was not justified by fundamental factors.

Japan has accumulated reserves since the beginning of floating exchange rates. It has not, however, done so at an exceptional rate. Chart C-I shows the growth in Japanese reserves from 1973 to 1981, expressed as an index with 1973=100. For comparison purposes the growth of total world reserves is also shown. Japan's reserves have growth much less steadily than the world total -- in particular, Japanese reserves fell sharply in 1979 when the Bank of Japan was intervening to support the yen -- but on average they have grown about as fast as the reserves of other countries.

Japan has also on average run a current account surplus since 1973. This surplus, however, has been small: on average only 0.15 percent of GNP from 1973 to 1981. The Japanese surplus relative to GNP was actually less than that of the U.S. over the same period (0.16 percent) and much less than that of Germany (0.45 percent).

In fact, it can be argued that the Japanese current account surplus has been too low. With free capital mobility, a country with a high savings rate such as Japan would be exporting capital on a large scale which would have as its counterpart a large current account surplus. Since Japan runs deficit on its services account, a balanced current account is consistent with a trade surplus. The relatively small size of Japanese surpluses may be the result of Japanese controls on capital outflow, which as discussed below have tended to prevent the weakening of the yen.

Recent undervaluation: The yen has depreciated sharply against the dollar in 1982, with the exchange rate going from 220 at the end of 1981 to a low of 275 in early October. However, the currencies of all of our major competitors have depreciated substantially against the dollar in the past two years. The question is whether the depreciation of the yen is fully accounted for by the general strength of the dollar, or whether there is some extra depreciation of the yen which might be attributable to factors specific to Japan, including Japanese policy.

Chart C-II provides some evidence. It shows a calculation of the percentage undervaluation of the yen, the German mark, and the French franc over time on the assumption (heroic but illustrative) that the average real exchange rate (the exchange rate corrected for differences in price levels) for 1973-81 represents a equilibrium level. As the chart shows, all these currencies were in this particular sense greatly undervalued by summer 1982; but the mark and the franc were actually more undervalued than the yen. The numbers for July 1982, the most recent data for which all the data are currently available, are given in Table C-I. As of July, the Yen was clearly less undervalued by this measure than the currencies of other major competitors. (Further decline in the yen this fall has narrowed but still not eliminated this difference.)

CHART C-I

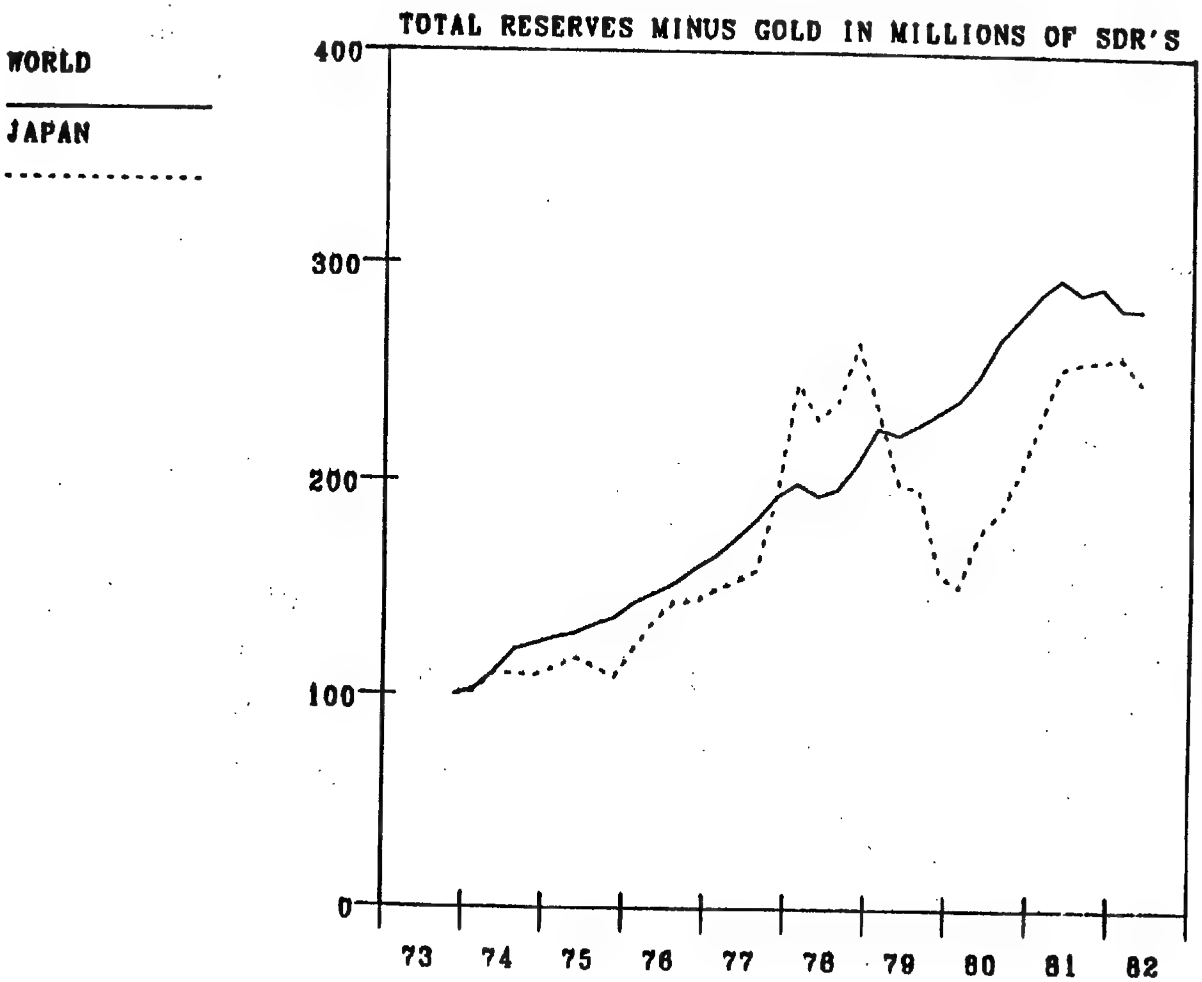
TOTAL RESERVES MINUS GOLD IN MILLIONS OF SDR'S
WORLD
JAPAN
400
300
200
100
0
73
74
75
76
77
78
79
80
81
82

CHART C-II

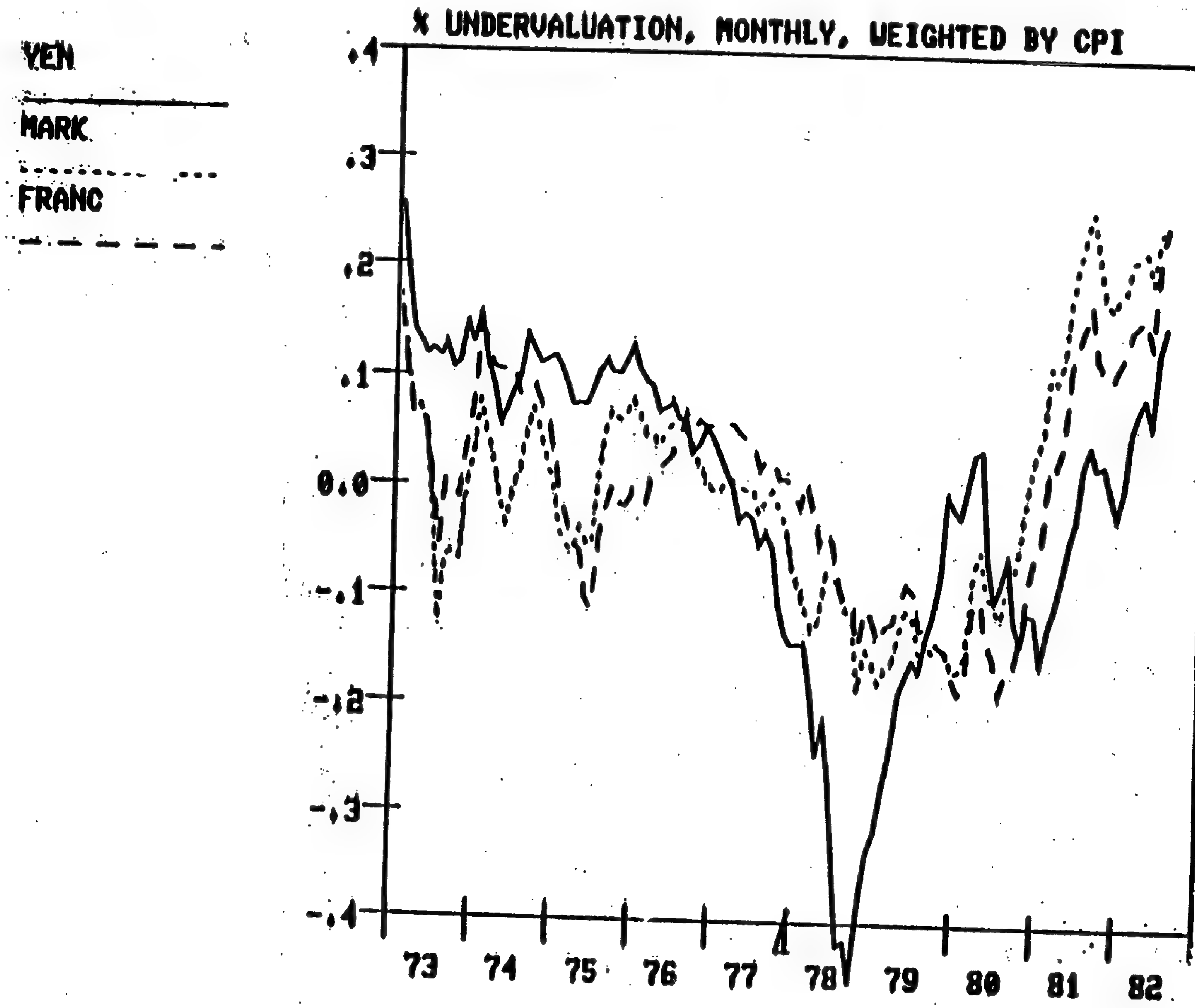

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Table C-I: Deviations of Exchange Rates from Assumed Long-Run Equilibrium Parities, July 1982

	Yen	Mark	Franc
Actual rate	255	2.46	6.85
Assumed Equilibrium rate	216	1.85	5.15
% undervaluation	15.4	25.0	24.7

Source: Based on data from the International Monetary Fund

Many of the complaints by the U.S. businessmen are based on such "purchasing power" calculations. While it is true that exchange rate changes will reflect shifts in relative purchasing power of currencies over the longer-term, the approach is not a useful guide to evaluation of exchange rate relationships at any particular point in time. First, it ignores the myriad economic, financial and political factors that can -- and should -- influence exchange rates over short to intermediate periods. Second, practical application of the concept faces serious technical problems related to selection of appropriate indicies, base periods, weighting schemes, etc.

Nevertheless, even if one accepts such measures to assess the assertions by the business groups, there is nothing in the evidence to suggest either that the yen has persistently been undervalued, or that the recent depreciation of the yen has posed a special problem.

The Japanese trade surplus in manufactures: The question remains how to reconcile this evidence with the general impression of overwhelming Japanese competitiveness. The reason for this perception is probably that Japan runs a large surplus in trade in manufactures to offset large deficits in trade in raw materials and services. Table C-II shows the makeup of the Japanese and U.S. balance of payments in 1981, a year in which the U.S. ran a surplus on current account and Japan ran a deficit.

Table C-II: Foreign Trade of U.S. and Japan, 1981 (billion dollars)

	Japan	U.S.
Trade balance in manufactures	+122.0	+19.9
Trade balance in primary products	-106.8	-47.8
Other Trade	+5.2	-
Net Trade	+ 20.4	-27.9
Balance on services and transfers	- 15.6	+32.4
Current account	+4.8	+4.5

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2. Financial Market Developments and Restrictions.

Liberalization and internationalization of the Japanese financial system is an objective the U.S. Government has pursued very actively with Japanese financial authorities. In our view, such changes will result in a more efficient world-wide allocation of resources, both real and financial, and permit a freer play of competitive market forces. Accordingly, we have impressed upon Japan in numerous bilateral meetings and in the Trade Subcabinet that it is important to us, to the world trading community and to the Japanese people that Japan fully open its financial system to foreign participation. In particular, we have advocated permitting foreign borrowers to raise yen financing through the Japanese bond market and commercial banking system on a timely and unrestricted basis.

Historically, Japan's financial system has been highly controlled. However, in recent years, Japan has significantly liberalized controls on both inward and outward capital flows. (See Annex 1 for a detailed discussion of liberalization measures.)

A major step was taken in 1980 with the implementation of the Amended Foreign Exchange Control Law which freed all transactions in principle. Liberalization has continued this year, partly in response to U.S. pressure. For example, the U.S. Export-Import Bank reached an agreement with the Japanese authorities providing for access to yen loans under Exim guarantee to finance U.S. exports; several U.S. companies have floated bonds in Japan without being subjected to established Japanese standards for unsecured bond issues; and Japanese securities firms announced that effective in January of 1983, the maximum wait in the queue for foreign yen bond issues in Japan would be cut from one year to one quarter, a AAA rating would automatically qualify a borrower to issue yen bonds in Japan, and the limit of one foreign corporate yen bond issue per quarter would be eliminated. In terms of policy orientation, as part of the second economic liberalization program announced last spring, Japan stated its intention of paying due consideration to further facilitating foreign borrowers' access to the Japanese financial system.

Despite significant liberalization, substantial Japanese financial controls, affecting both capital outflows and inflows, remain in place; many of them operating through administrative guidance rather than explicit regulations. The Japanese authorities contend that these are maintained for prudential, balance of payments, and domestic monetary control reasons. (See Annex 2 for detailed discussion of Japan's capital controls.)

The controls on inflows -- primarily relating to position controls preventing banks in Japan from increasing net foreign currency liabilities, and discouragement of overseas yen borrowing by residents -- may be effective in restraining inflows at a time when the yen is experiencing sharp demand. In contrast, the controls on outflows primarily operate to limit foreign access to yen

financing in the Japanese bond market and through the commercial banking system. Existing controls appear to be geared towards discouraging inward and outward transactions by Japanese residents more than by non-residents.

It seems evident that an important reason for the remaining restrictions on capital outflows is the concern of Japan's Ministry of Finance (MOF) that increased foreign access to yen financing through the bond market and banking system tends to accelerate capital outflow from Japan and add to downward pressures on the yen. On foreign access (capital outflows), Japan maintains formal restrictions on syndicated bank yen lending and informal "supervision" of foreign yen bond issues in Japan. The MOF individually surveys banks' yen lending intentions and subsequently discusses this survey with bankers and presents its general policy overview. The MOF's present stance is to permit yen loans of 580 billion yen ($2.3 billion equivalent) in the October 1982-March 1983 period. This constitutes a slight relaxation from the prior six-month period. With respect to foreign yen bond issues in Japan, MOF no longer sets quantitative ceilings. However, the Japanese securities companies are well aware of the MOF's concerns regarding the yen's weakness and may themselves limit foreigners' ability to float yen bonds. (For discussion of specific criteria applied see Annex 2.) We understand that several foreign bond offerings planned for the fourth quarter of 1982 are presently being withdrawn, and there thus appears to be no current need for MOF to express a specific view regarding a maximum level of yen bond issues.

Japanese financial market controls have undoubtedly held the Japanese interest rate structure below market clearing levels. Nevertheless, it is unlikely that a market clearing level of interest rates would be sharply higher than the observed one. Relatively low Japanese nominal interest rates are fundamentally associated with Japan's success in keeping inflation low. In fact, real Japanese interest rates have tended to be relatively high by international standards. Furthermore, given the Japanese moves towards integration with the international financial market that have already taken place and the slack domestic demand for credit associated with the slowdown of the Japanese economy, it seems very unlikely further liberalization of financial flows would force Japanese interest rates so much higher as to attract significant capital inflows.

Moreover, it is not a foregone conclusion that a narrowing in U.S.-Japanese interest differentials would strengthen the yen. Since early July, U.S.-Japanese short-term interest differentials have narrowed 4.5 percent, yet the dollar has appreciated 6 percent against the yen. Exchange rates reflect many factors besides interest rate differentials.

With increased liberalization, capital flows in and out of Japan have increased dramatically in recent years. In 1981, Japanese residents' net long-term capital outflows totalled $22.8 billion and net long-term non-resident inflows $16.3 billion.* This compares with annual averages of only $4.0 and $2.3 billion respectively in 1974-76. Gross inflows and outflows on non-resident transactions associated with Japanese bonds, stocks, and repurchase agreements amounted to $78 and $63 billion respectively in 1981, as compared with annual averages of only $3.6 and $2.9 billion respectively in 1974-76.

The effects of recent actions to facilitate foreign access to yen financing are also evident in increased transactions. In the first three quarters of 1982, the amount of yen financing raised by foreigners exceeded that for all of 1981. However, it is unlikely the third quarter pace will continue into the fourth quarter, as the majority of scheduled foreign bond issuers are withdrawing commitments to float bonds in view of narrowing international interest differentials and a perceived increase in exchange risk.

Foreign Yen Financing in the Japanese Financial Market
(billions of yen, dollar billions in parenthesis)

	Banks' Syndicated Yen Lending	Bond Issues: Public	Bond Issues: Private	Total
1978	¥ 531 ($2.5)	¥ 722 ($3.4)	¥ 105 ($0.5)	¥ 1,358 ($6.4)
1979	803 (3.7)	333 (1.5)	67 (0.3)	1,203 (5.5)
1980	100 (0.4)	261 (1.2)	0 (0.0)	361 (1.6)
1981	322 (1.5)	495 (2.2)	108 (0.5)	925 (4.2)
1982				
Q1	164 (0.7)	193 (0.8)	50 (0.2)	407 (1.7)
Q2	116 (0.5)	170 (0.7)	50 (0.2)	336 (1.4)
Q3	276 (1.1)	195 (0.8)	45 (0.2)	516 (2.1)
1982: Q1-3	556 (2.3)	558 (2.3)	145 (0.6)	1,259 (5.2)

* This year, Japan reclassified foreign investments in repurchase investments as a short-term capital flow. In 1981, net foreign investments in this instrument were $3.2 billion.

The charge that foreign demand for and speculation in yen is deterred by the uncertainty created by a widespread perception that the Japanese financial market is tightly controlled and subject of abrupt changes in policy objectives is contradicted by the substantial increase in the flow of non-resident funds in and out of Japan. This suggests that non-residents are increasingly able to avail themselves of increased investment opportunities in Japan when market conditions are attractive. One would expect that as investors gain experience with the increasingly liberalized Japanese environment, perceptions about regulatory uncertainties and risk should dissipate. In any case a sophisticated investor can factor this perception into any risk assessment. Also speculation in yen is quite easy -- the Euro-yen market has grown to $30 billion equivalent; futures contracts in yen are readily available on Chicago's International Monetary Market; and an investor can readily buy Japanese bonds, stocks, and short term instruments (which can be rolled over) in Japan.

In sum, the Japanese financial system is by no means as well integrated with the rest of the world as we would like. But the size of capital flows has become too large, and the liberalization efforts have been too significant to suggest that Japanese financial markets are any longer tightly isolated from overseas centers.

3. Relationship of Yen Value to Market Restrictions

It is important to recognize that -- at least in the short term -- greater foreign access to both Japanese goods and financial markets tends to exert downward pressure on the yen and that this has been a factor in recent developments. Both an increase in Japanese imports and greater foreign borrowings of yen coupled with subsequent conversions increase the net supply of yen on the exchange markets. A judgement on the longer run effect of internationalization of the yen on the yen's exchange rate is more difficult to make. Certainly, greater access would increase demand for yen for use internationally. At the same time, however, greater liberalization would increase the ability of Japanese residents to channel their high savings to overseas financial centers.

4. Japanese Economic Situation

In addition to generalized dollar strength, there are several factors specific to Japan which may explain the yen's present weakness. Despite Japan's large bilateral trade surplus with the United States, its overall external performance in 1982 has been much weaker than previously anticipated. Japan's seasonally-adjusted current account surplus of $5.1 billion through August ($2.8 billion non-seasonally adjusted) -- about $7-1/2 billion at annual rate -- contrasts with earlier private, government, and international organization forecasts of $16 to 20 billion. In the third quarter of 1982, Japanese export volume was down 8 percent

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from the same period in 1981, reflecting slack international demand for Japanese goods as well as Japanese export restraints in the face of mounting protectionist pressures overseas. Japanese export restraints, by depressing the level of exports and related foreign demand for yen, and protectionist pressures, by lowering market expectations of future levels of Japanese exports earnings, may have contributed importantly to the yen's current weakness.

Given its very high domestic savings rate, Japan has historically tended to be a net capital exporter to the rest of the world. This has been particularly true in 1982. Through August of this year, average monthly Japanese resident net long-term capital outflows amounted to $2.4 billion, as opposed to average monthly outflows of $1.9 billion in 1981.

The effect of this capital export bias on the exchange rate of the yen has been reinforced this year by a dramatic tapering off in foreign long-term capital inflows. Through August, average 1982 monthly foreign long-term capital inflows amounted to $550 million versus average monthly inflows of $1.1 billion in 1981. The slowdown in foreign inflows reflects poor Japanese stock and bond market performance, higher real yields available in other overseas centers, and yen weakness.

An important factor that may help explain the recent yen weakness has been monetary expansion in Japan since early 1981. Targeted money growth, M2 plus CDs, grew in excess of nominal GNP, on average, by over 6 percent from the fourth quarter of 1981 to the second quarter of 1982. This excess supply of money could place downward pressure on the yen, being dissipated primarily through capital outflows. In this case, yen weakness in foreign exchange markets would be the outcome of market forces adjusting to an excess supply of money stemming from Japanese domestic monetary policy.

The Japanese authorities have repeatedly assured us that they would like to see a strong yen, and these assurances have some credibility. In view of the stagnant economy, the Japanese authorities would like to stimulate domestic demand but have felt the weakness of the yen to be a constraint. Japanese fiscal policy is presently oriented towards cutting budgetary deficits and expenditures, though the conviction with which they pursue this objective may lessen with the departure of Prime Minister Suzuki. In recent years, annual Japanese budget deficits have been around $60 billion, or 5-1/2 percent of Japanese GNP. In terms of monetary policy, the Japanese authorities have been reluctant to cut official interest rates for fear that this would cause the yen to weaken further. In fact, during the spring, they pushed short-term rates modestly higher in order to defend the yen, contrary to their domestic economic objectives.

5. Japanese Intervention and Reserves

Japan has also intervened vigorously in the exchange markets this year in order to support the yen. This intervention is partly reflected in official Japanese reserve holdings which at the end of September were down $4.4 billion from the beginning of the year, despite substantial interest earnings.

D. POSSIBLE U.S. POLICY RESPONSES.

1. Attitude toward yen valuation.

Does the alleged undervaluation of the yen represent a special problem, requiring special U.S. action? The evidence does not suggest that it does. First, the recent fall in the yen is best seen as part of a general strengthening of the dollar, rather than as a specifically Japanese phenomenon. If anything, recent Japanese intervention and monetary policies have been intended to limit rather than accentuate the yen's decline. Until very recently, on the basis of the purchasing power calculations referred to above, any "undervaluation" of the yen relative to historical levels was substantially less than that of our other major competitors.

Second, there is no evidence supporting the view that the yen has been persistently undervalued since floating exchange rates began. Although Japan has run large surpluses on manufactured goods trade, its overall current account surplus relative to GNP has been smaller than that of other industrial countries, including the U.S.

A target for the yen?: Should the U.S. have a target value for the yen, and press Japan to change policy to move it there? This would amount to the U.S. demanding a policy from Japan which it has rejected for itself. The U.S. view is that intervention to achieve exchange rate targets is almost always counterproductive. We do not know what the "right" value of the dollar is, and any attempt to peg it at some particular value will create pressures to interfere with the free movement of capital and goods. The U.S. can legitimately ask Japan to liberalize its financial system, which may either raise or lower the yen.

Recommended Stance:

-- The U.S. cannot reasonably demand of the Japanese that they stop depressing the yen when they have not in fact been doing so, and are currently in fact supporting it.

-- We cannot preach the virtues of a free exchange rate for ourselves while demanding that others orient their policy towards achieving a particular rate.

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2. U.S. pressures for liberalization of the Japanese financial system.

Liberalization and internationalization of the Japanese financial system parallels USG efforts to open the entire Japanese economy to foreign participation. In the long-run, opening up the Japanese financial system would permit a more efficient allocation of global financial resources; give U.S. firms competitive access to yen financing and permit fairer and increased global competition.

At least in the short-term, greater access to the Japanese financial system will weaken the yen, and this has been a recent factor in the yen's weakness. Japanese reimposition of short-term controls on capital outflow (such as an "interest equilization tax") would tend to strengthen the yen and perhaps considerably so, but run counter to the liberalization objective.

In the recently concluded National Security Study on U.S-Japanese relations, it was agreed that the U.S. should press Japan to open its financial system, even if this should place further downward pressure on the yen.

Recommended Stance:

-- The U.S. should continue to press Japan to liberalize and internationalize its financial system, recognizing that this may put added downward pressure on the yen, at least in the short-run. The U.S. should not ask Japan to place capital controls on outflows.

3. Japanese Policy Mix.

The Japanese budget deficit, at 5-1/2 percent of GNP, far exceeds that in the U.S., and it is understandable that Japan would seek to cut expenditures and deficits. Indeed, we are trying to achieve the same objectives.

Recommended Stance:

-- That the USG not press Japan to relax its efforts to get budgetary expenditures and deficits under control in order to change its policy mix, tighten money, and raise interest rates.

4. Japanese/U.S. Foreign Exchange Market Intervention.

Japan has intervened vigorously in the exchange markets to support the yen, as reflected in a decrease in its reserves of $4.4 billion through September, despite substantial interest earnings.

The Reagan Administration has taken the position that the sheer size of the exchange markets creates potential forces far exceeding the ability of governments to control or direct exchange rates and that the judgement of the marketplace is superior to that of the government. For these reasons, we have taken a minimalist attitude towards exchange market intervention and allowed the markets to operate freely without interference except in the case of extreme disorder.

In our judgement, Japanese exchange market intervention has not been successful in reversing the depreciation of the yen. However, it has been oriented towards strengthening the yen; is not out of line with practices by other governments; and is not inconsistent with Japan's international obligations.

Recommended Stance:

-- We should not urge Japan to try to strengthen the yen through foreign exchange market intervention; and similarly should oppose calls for the U.S. to intervene in the exchange markets to strengthen the yen.

5. Japanese practice of not selling official interest receipts on dollar holdings into the exchange markets.

Japan does not automatically sell its interest receipts into the exchange market and on balance, this may marginally lower the yen exchange rate. However, many major countries, including the U.S., also do not automatically convert foreign currency interest receipts into local currency. (Only Germany does so and it chooses the time it conducts such sales to coincide with its exchange market objectives.)

In the past, we have told Japan that if it wanted to strengthen the yen without going against the principle of non-intervention, one way to do so would be to sell its interest receipts.

This year, Japan in supporting the yen, has sold an amount of dollars far in excess of its interest receipts as reflected in the decline in Japanese reserves. If interest receipts were sold in the market as a matter of course, this would presumably affect the extent of Japanese intervention.

Recommended Stance:

-- Do not press Japan on this issue at this time. If we want to pursue the issue as a matter of principle, we should pursue it with all major countries and not just Japan.

6. Action in IMF.

Japan is reviewed annually within the IMF surveillance framework, which includes review of exchange rate policies. The most recent examination early in 1982 did not conclude that the exchange rate was being manipulated.

Launching a special Article IV examination of Japan would represent a serious allegation by the U.S., and the USG would need persuasive evidence that Japan was manipulating the yen to enhance export competitiveness. As this paper makes clear, though Japan retains controls over capital flows and the the yen has depreciated, this does not mean Japan is manipulating the rate to depreciate the yen and gain competitive advantage.

More generally, the USG is concerned about the divergence of economic policies among countries, not only vis-a-vis Japan, but among all the major countries. At Versailles, we initiated an approach to cooperation among the major economies. We are closely reviewing the relative policy stances and striving to achieve greater policy convergence over the medium-term, which is the appropriate approach to achieving greater stability in exchange rates.

Recommended Stance:

-- We should not initiate IMF action against Japan. We should continue our efforts to intensify policy convergence through our initiative launched at the Versailles Summit.

7. Imposition of a variable duty on U.S. imports from countries with "undervalued" currencies.

There would be legal and technical problems associated with the unilateral imposition of a variable import levy on a country-by-country basis by the United States. Presumably the levy would be computed -- perhaps monthly -- on the basis of an estimation of the degree of undervaluation of the currency of each country from which we import.

On the legal side, such a measure would be illegal on two grounds. First, the tariff increase itself would not be justified by GATT balance of payments rules. Secondly, country-by-country tariffs would be an egregious violation of GATT Article 1 (unconditional most favored nation treatment).

On the technical side, we are not able to define or estimate whether or not a country's currency is undervalued, let alone by how much.

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Recommended Stance:

-- The USG should oppose this proposal on the grounds that it is protectionist and could harm the global free trade system. Moreover, a variable duty on imports from Japan would further depress Japanese exports and exacerbate the yen's weakness.

Classified by Marc E. Leland
☐ Declassify ☒ Review for
Declassification on 10/25/88

Annex 1: JAPANESE LIBERALIZATION MEASURES

Key liberalization measures taken in recent years have been:

1979 - Replaced administered interest rates with market determined rates for most short-term money market instruments.

- Eliminated reserve requirements on free yen deposits.

- Eliminated maturity prohibitions on non-resident purchases on Japanese securities.

- Lifted restrictions on period for conversion on yen proceeds by non-resident borrowings via bonds or syndicated bank lending.

- Non-residents given access to gensaki market.

1980 - Free yen accounts held by foreign official entities exempted from interest rate ceilings.

- Authorized foreign exchange banks allowed to transfer funds from abroad through their inter-office free yen accounts.

- All commercial banks allowed to make impact loans.

- Implemented "Amended Foreign Exchange and Foreign Trade Control Law." This law embodied principle that all foreign transactions were free unless specifically prohibited. Law codified previous liberalization measures, but also permitted residents to hold unlimited foreign currency deposits and removed screening process for impact loans.

1981 - Relaxed ceilings on foreign yen bond issues and syndicated bank yen lending.

1982 - As noted in the text, this year Japan has dropped administrative guidance concerning eligible borrowers of yen loans;

- U.S. Export-Import Bank reached an agreement with the Japanese authorities providing for access to yen loans under Exim guarantee to finance U.S. exports;

- Several U.S. companies have floated bonds in Japan without being subjected to established Japanese standards for unsecured bond issues;

- Japanese securities firms announced that effective in January of 1983, the maximum wait in the queue for foreign yen bond issues in Japan would be cut from one year to one quarter, a AAA rating would automatically qualify a borrower to issue yen bonds in Japan, and the limit of one foreign corporate yen bond issue per quarter would be eliminated;

- As part of its second economic liberalization program, Japan announced that it would pay due consideration to further facilitating foreign borrowers' access to the Japanese financial system.

- In the period ahead, we know Japan is actively considering establishment of an international banking facility including use of the yen and moving away from traditional reliance on collateralized domestic bond issues towards assuring creditworthiness through the bond rating agencies.

Current Japanese attitude toward internationalization of the yen.

Japanese financial authorities appear to have accepted the inevitability of an increased the international role for the yen. To the extent internationalization occurs, however, Japanese authorities wish to see it happen under their eyes.

The authorities main concern regards the implications of internationalization in lessening their control over the Japanese domestic financial apparatus, and in particular the implications for ceilings on deposit rates and financing of the government's large budget deficits.

In general, the Ministry of Finance, and in particular its International Finance Bureau, has been a more active proponent of internationalization than the Bank of Japan.

Annex 2: JAPANESE CAPITAL CONTROLS

Japanese Controls on Outflows

1. Quantative ceilings on foreign access to syndicated bank yen lending and the Japanese bond market.

In addition to subject text discussion, it should be noted that it is expected that there will be four public offerings per month with offerings varying between ¥ 10-20 billion each depending on the creditworthiness of the borrower plus whatever issues MDBs might conduct and three or four private placements of a maximum amount of 45 billion each.

The three U.S. companies that floated yen bond issues in Japan this year are Proctor and Gamble, National Cash Register, and Dow Chemical. No foreign corporate bond issues are planned in the fourth quarter as no foreign companies expressed interest. We have indications that two companies are willing to float yen bond issues but not at the present time.

2. Japanese Bank Participation in foreign currency loans abroad.

The MOF has determined that banks in Japan will be permitted to lend overseas in foreign currencies around $8.5-9 billion in the October 1982-March 1983 period. This is about the same level as in the prior six-month period. This amount is consistent with the sum of individual bank projections. This figure applies to all foreign currency lending done by banks' head offices in Tokyo and their overseas branches; it does not include subsidiaries or short-term loans of less than one year. The primary source of funding for foreign currency lending is Euromarket deposits.

3. Japanese life insurance companies are restraining investments in foreign securities to 10 percent or less of the increase in their assets.

4. Zero Coupon Bonds. Japanese authorities issued administrative guidance early this year to halt resident investments in dollar denominated discount bonds. There had been outflows of $1.2 billion into this instrument in the first two months of 1982. The Japanese argued this was done to close a tax avoidance/evasion loophole. (At the time, the Japanese Diet was considering a proposal, now apparently shelved, to tighten reporting on interest earnings for tax purposes. Capital gains on discounted instruments are not taxable under Japanese law.) Recent reports indicate that investors have sold off over half of their zero coupon bonds to take advantage of capital gains and dollar appreciation and because the apparent shelving of the proposal to tighten interest reporting requirements has reduced the tax angle incentive to hold zero coupon bonds.

Japanese Controls on Inflows

1. Spot position controls on foreign currency assets and liabilities of banks in Japan.

Spot position controls operate to limit increases in the net foreign currency liabilities of banks in Japan, although they do not limit their net foreign asset position in foreign currencies. The basic concern behind the institution of spot position controls was that banks should not be allowed to over-borrow abroad. The main exception to these position controls is the swap lines, largely for foreign banks, which allow banks to swap foreign currency into yen. It is our understanding that the swap lines have been increased by about $1.3 billion this year, to roughly $6.8 billion.

2. Yen borrowing overseas by residents.

The authorities do not generally favor yen borrowing overseas by residents, and in practice such borrowing is generally limited to private placements of the yen bonds with OPEC investors and certain government guaranteed issues. Similarly, foreign currency bond issues abroad with long-term forward yen cover are generally frowned upon because of their similarity to a yen issue. The reason for this attitude appears to be that as a matter of policy Japan prefers that yen transactions take place in Japan. This probably reflects a desire to abe able to monitor the transactions, maintain control over domestic interest rates, and possibly commercial considerations.

3. Foreign currency convertible bond issues abroad by Japanese corporations.

A rush of such issues in the fall of last year caused prices to fall and left underwriters with losses on unsold issues. Some degree of restraint was subsequently imposed.

4. Foreign trade financing.

Deferrred payments for imports and import usance credit require special approval if the maturity involved is over one year. Similarly, advance payments for exports received over one year in advance require special approval. These provisions are holdovers from earlier provisions concerning the standard method of settlement and presumably reflect a desire to monitor Japanese borrowing abroad and to limit the potential for leading and lagging payments and receipts.

5. Foreign investment in Japanese real estate.

Investment in Japanese real estate for speculative purposes is controlled. Such control probably reflects concern about the already high cost of land in Japan and the relative shortage of land.

6. Foreign transactions in call money and commercial discount bills.

These are inter-bank markets, with participation restricted to financial institutions in Japan, including foreign banks in Japan. These markets are not open to non-financial institutions in Japan, nor to banks or non-banks abroad. These are the markets in which the Bank of Japan implements its monetary policy.

7. Direct investment in Japan.

Despite substantial liberalization of direct investment laws and practices, the actual level of foreign direct investment in Japan in 1981 was very small at $189 million. This amount represents only a fraction of net 1981 Japanese direct investment overseas, which amounted to $4.9 billion. Japan has undertaken substantial liberalization of formal controls on direct investment. The Amended Foreign Exchange Law implemented in 1980 permitted all direct investments in Japan in principle. One hundred percent foreign ownership is restricted in only four industries (agriculture, forestry, and fisheries; mining; petroleum; and leather and leather products) and eleven designated firms. Japan's investment screening process was replaced with an investment pre-notification process. Although individual investment notifications continue to be subject to review by individual ministries under the new law, no case of modification or prohibition of an investment proposal has been reported. Also, in May of 1982, the Government of Japan included in its liberalization program an official statement welcoming foreign direct investment in Japan.

The small level of foreign direct investment in Japan may reflect other factors affecting the investment environment such as high entry and fixed operating costs; local licensing procedures; Japanese practices which limit the scope for acquisitions by both Japanese and foreign firms; and the complexity of the distribution system.

In our discussion with the Government of Japan, the U.S. has encouraged Japan to make its pre-investment notification procedure more transparent, either by publicly indicating what factors would cause the government to modify or reject an investment, or to modify the procedure by substituting simple investment registration for notification to the Government of Japan. In addition, we have generally pressed for national treatment for U.S. companies in Japan and solicited concrete Japanese measures to implement its stated policy of welcoming foreign direct investment.